The 2004 American Jobs Creation Act Creates Much Needed Domestic Tax Incentives for Independent Film Producers

Both federal and numerous state governments, including Montana, have enacted innovative tax related incentives which attempt to make the U.S. a more tax friendly venue for producing and financing independent films and certain other media. Canada retains a strong competitive position, however. The remainder of this article will discuss the competing tax incentive programs in the U.S. and Canada (specifically Montana vs. Alberta)

U.S. Federal Tax Incentives

The most valuable incentive is included in new Internal Revenue Code Section 181, enacted as part of The American Jobs Creation Act of 2004, an elaborate package of tax measures passed by Congress and President Bush in October 2004. The Jobs Creation Act covers a wide variety of tax matters which have gained a great deal of publicity. However, with little fanfare, the Act included what could be the most significant tool for changing the independent film financing landscape as we know it.

The Act is designed to stimulate investment in film by granting a 100 percent write-off for the cost of film and television productions in the year the cost is incurred. The incentives are available for “qualified productions” commencing after October 22, 2004, and before January 1, 2009. Qualified film and television productions include any production of a motion picture (whether released theatrically or otherwise). The Act also covers miniseries, scripted, dramatic television episodes and movies-of-the-week.

The Act benefits producers and production companies by granting an immediate tax deduction for the full costs of a production in the year the costs are incurred (as opposed to having to spread or amortize those costs over a period of years). Deducting the costs up front while deferring the income from the film until later years when it is actually incurred will significantly reduce or eliminate taxable income for the film in the first years of exploitation. Also, production costs are not just defined as the film’s budget. Costs may include all direct and indirect costs of producing the film, including, development costs, an allocation of general and administrative costs based on a portion of production expenses, depreciation of property used in the production, and financing costs.

The new federal tax program applies to those films that have production budgets between $1 and $15 million, and spend at least 75 percent of their total “qualified compensation” on work performed in the United States. “Qualifying compensation” includes payments for the services performed in the U.S. by actors, directors, producers and production personnel. The budget cap increases to $20 million where the production and expenditures are in designated “depressed areas” and communities.

The relatively modest minimum budget threshold of the federal tax program (minimum of at least $1 million) makes this provision a user-friendly tool for independent film producers, many of whom cobble financing from a variety of investment sources including private equity investors. In the typical scenario, where a film is co-produced by numerous investors, the deduction for qualifying expenditures must be apportioned among the investors/owners of the film in a manner that reflects each investor’s proportionate investment and economic interest in the project.

Electing to use the new law also simplifies the tax reporting process. Under prior law, film expenses were most often depreciated under the income forecast method. For first-time filmmakers and start-up production companies, predicting revenues for the ten years after the film is completed is extremely difficult. Alternatively, film expenses could also be depreciated over 15 years, far exceeding most films’ revenue streams. Using the deduction up front, a producer or production company can use the tax loss to offset other passive income with any excess to be carried over to future years. Please note that a film produced in Canada is not eligible for the Section 181 benefits, and either the income forecast method, or 15 year straight line amortization method must be used to deduct expenses.

In addition to Section 181, a U.S. produced film may also allow the film producer to claim benefits under new Section 199 as income is generated from exploiting the film. The deduction available under Section 199 is equal to 3%[1] of the lesser of taxable income or “Qualified Production Activity Income”, and is further limited to 50% of W-2 wages paid for the year.

[1] Increases to 6% for 2007-2009, and 9% for tax years beginning in 2010 and later.

Montana Tax Incentives

In addition to the federal tax incentives, the State of Montana has enacted legislation providing for two (2) refundable tax credits. The first is related to wages paid to Montana residents (12% on up to $50,000 of annual wages paid per Montana resident); and the second is related to expenses incurred in Montana related to qualifying expenditures made in connection with the production (8% of the qualified expenditures). Qualified expenditures includes Montana expenditures for lodging expenses, restaurant and food expenses, location fees, lumber and construction materials, rental of production equipment and vehicles, and supplies and materials that will be used in the production. The combined limitation on the credits is $1 million per film project.

The combination of the federal and Montana tax incentives makes a very strong case for producing a film in the U.S. However, as stated earlier, Canada offers some generous incentives as well.

Canadian Tax Incentives

Canada offers tax incentives to foreign film producers that employ the services of Canadians. The incentive is called the Film or Video Production Services Tax Credit, or ("PSTC"). An eligible foreign film producer can earn a refundable tax credit equal to 16% of its qualified Canadian labor expenditures, net of any assistance, in respect of an accredited production for services rendered in Canada by Canadian residents. There is no limit on the amount of the credit. In order to receive the PSTC, an eligible production corporation must obtain an accredited film or video production certificate from the Canadian Audio Visual Certification Office (CAVCO) in respect of an accredited production. The accredited production must meet a cost minimum (more than $1,000,000 for the 24-month period after the start of the main photography) and it must be of an eligible genre as set out in the proposed Income Tax Regulations (the Regulations). Finally, the PSTC may be assigned to a creditor to assist with financing the production.

The foreign film producer does not need to have a Canadian corporation to claim the PSTC, thus, future profits from the exploitation of the film will not be taxed in Canada.

In addition to the federal tax incentives, the Alberta Foundation for the Arts offers grants for film development. These grants are formula driven and equal 20% of the production costs incurred in Alberta, up to a maximum of $1.5 million. The grants are available for Alberta based and controlled companies only, and are generally not available to foreign film producers.

Conclusion

A U.S. film producer must balance the ability to claim the benefits of the new Section 181 deduction and the Montana state credits with the tax credits and potential grants available in Canada. The loss of the Section 181 and Montana benefits appears to be more detrimental than the potential benefits related to receiving the Canadian credits. The smaller the film's budget, the more beneficial the Section 181 incentive becomes. This is illustrated below in our analysis of the competing tax results for various size film budgets.

Finally, the American film industry received yet another boost courtesy of the increase of the Canadian currency against the United States dollar. Although Canada continues to offer some generous tax incentives, as a consequence of the currency fluctuation, foreign film productions in Canada have declined 40-plus percent from the peak years of 1999 and 2000.

The combination of the federal incentive and the Montana credit, plus the currency fluctuation in Canada, makes Montana an extremely attractive location for film producers.

The comparative table below illustrates just how powerful the new tax incentives can be for you.

TAX ADVANTAGE

Qualified Small Film
Tax Analysis
$20 Million Budget

	U.S. Production Section 181 Method	Canadian Production Income Forecast Method	U.S. Production 15 year S/L Amortization Method
Total Revenue	44,000,000	44,000,000	44,000,000
Total Expenses	20,000,000	20,000,000	20,000,000
Total Net Income	24,000,000	24,000,000	24,000,000
Total Federal Income Taxes Paid	7,749,000	8,400,000	11,200,000
Maximum Montana Production Credits	1,000,000		-
Canadian Production Services Tax Credit (PSTC)		1,600,000	1,600,000
Net positive cash flow	17,251,000	17,200,000	14,400,000
Net Present Value - taxes paid at 8%	5,058,258	6,377,601	8,662,641
Net Present Value - Entire Project at 8%	9,811,761	9,047,973	6,762,933
Internal Rate of Return	33%	28%	22%

* Assumes that 50% of Budget equals wages paid thus eligible for Canadian PSTC

* Assumes that no Alberta Grants are obtained.

TAX ADVANTAGE

Qualified Small Film
Tax Analysis
$15 Million Budget

	U.S. Production Section 181 Method	Canadian Production Income Forecast Method	U.S. Production 15 year S/L Amortization Method
Total Revenue	33,000,000	33,000,000	33,000,000
Total Expenses	15,000,000	15,000,000	15,000,000
Total Net Income	18,000,000	18,000,000	18,000,000
Total Federal Income Taxes Paid	5,848,500	6,329,167	8,400,000
Maximum Montana Production Credits	1,000,000		-
Canadian Production Services Tax Credit (PSTC)		1,200,000	1,200,000
Net positive cash flow	13,151,500	12,870,833	10,800,000
Net Present Value - taxes paid at 8%	4,075,163	4,980,030	6,812,958
Net Present Value - Entire Project at 8%	8,211,623	7,491,942	5,659,014
Internal Rate of Return	42%	35%	27%

* Assumes that 50% of Budget equals wages paid thus eligible for Canadian PSTC

* Assumes that no Alberta Grants are obtained.

TAX ADVANTAGE

Qualified Small Film
Tax Analysis
$5 Milion Budget

	U.S. Production Section 181 Method	Canadian Production Income Forecast Method	U.S. Production 15 year S/L Amortization Method
Total Revenue	11,000,000	11,000,000	11,000,000
Total Expenses	5,000,000	5,000,000	5,000,000
Total Net Income	6,000,000	6,000,000	6,000,000
Total Federal Income Taxes Paid	1,949,850	2,126,600	2,829,283
Maximum Montana Production Credits	400,000		-
Canadian Production Services Tax Credit (PSTC)		400,000	400,000
Net positive cash flow	4,450,150	4,273,400	3,570,717
Net Present Value - taxes paid at 8%	1,368,843	1,671,978	2,292,703
Net Present Value - Entire Project at 8%	2,811,644	2,508,509	1,887,783
Internal Rate of Return	43%	35%	27%

* Assumes that 50% of Budget equals wages paid thus eligible for Canadian PSTC

* Assumes that no Alberta Grants are obtained.